Quarterly Commentary April | 2021

Is inflation a threat to this bull market?

"The biggest risk to the stock market is ironically an economic environment that is too strong, prompting the return of inflation. Sustained levels of higher inflation will eventually prompt the Fed and other central banks to move from their current near zero interest rate stance. This will also lead to an increase in cash and bond yields, which at some point will once again compete for the same investment dollars that are flooding into stocks. We do not see this as a risk to the markets in 2021, possibly not even 2022. In this backdrop, we are tilted towards risk assets (stocks, corporate bonds, high yield debt) to benefit from the continuing recovery."

This quote is how we ended our commentary last quarter December 31, 2020. Since then, COVID–19 vaccinations have given people reason to be optimistic about the economy and a return to pre-pandemic activities. There have been over 5 million doses administered in Canada, and 148 million in the United States. Investment markets as leading indicators are expecting, and pricing in, a stronger economy as 2021 progresses. While the stock market usually receives the bulk of the attention in the investment world, it has been changes in the bond market that have been most talked about through the first quarter of 2021. The ten year U.S. Treasury bond yield (Chart 1) which troughed at 0.55% last August, and began the year at 0.93%, rose to a high of 1.74% during March. All this because of an improving outlook for the economy. A strengthening economy is a good thing, and this expectation is also reflected in the commodity markets, and we have seen a dramatic increase in lumber, copper and oil prices. Yet a material and sustained increase in inflation would not be positive for investment markets, since it may force the Federal Reserve and/or the Bank of Canada to begin a move towards raising rates much earlier than is widely expected. Like Goldilocks, investment markets prefer an economy that's not too hot, and not too cold. More porridge?

Chart 1: 10 Year U.S. Government Bond Yield

Source: Trading Economics

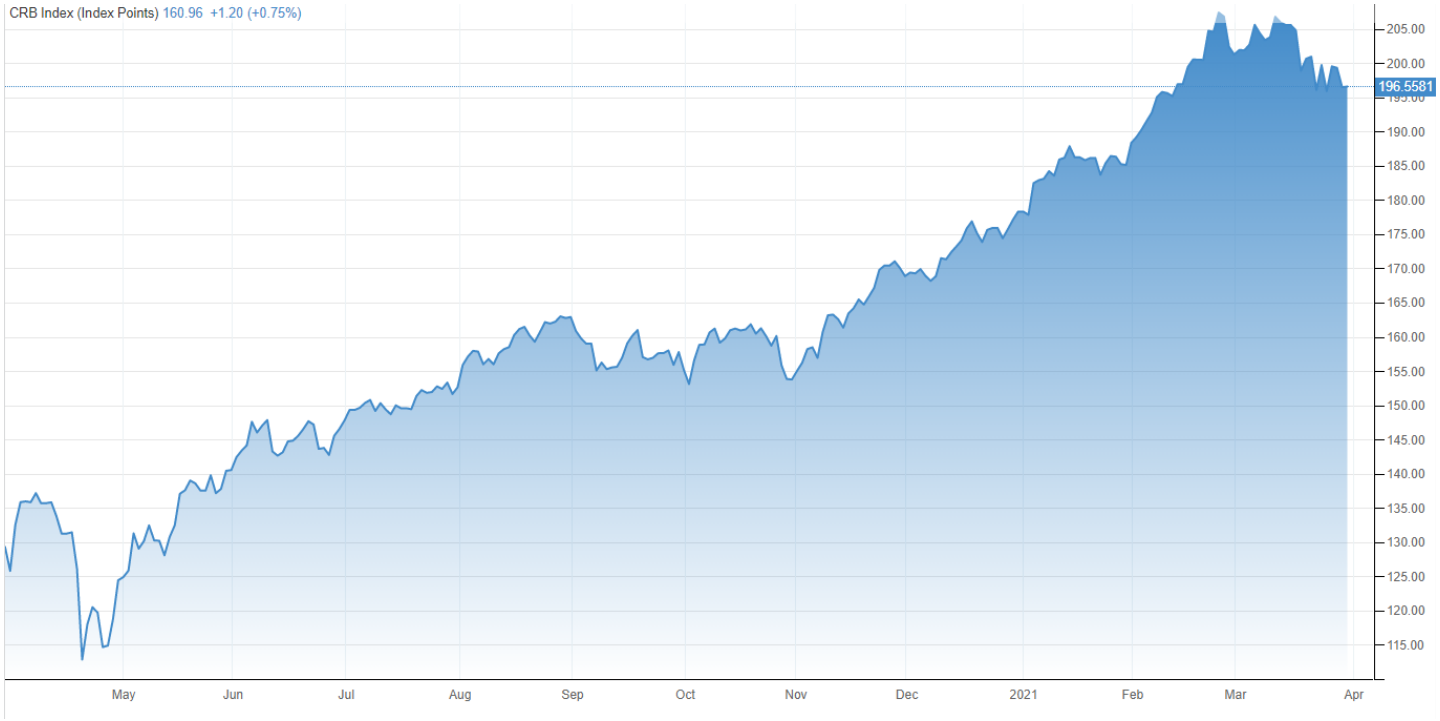
We are seeing inflationary pressures, and expect them to be elevated for much of 2021. Last year's activity shutdowns led to supply imbalances in many industries. The current, broad parts shortages are the result of these

supply chain disruptions. The recovery in manufacturing activity has many businesses having to outbid competitors for supplies, driving up prices for scarce parts. We also see similar issues within technology, as a shortage of semiconductors has impacted many industries, in particular the automotive sector. Commodity producers had shut facilities in order to preserve balance sheets during to the pandemic, but are now reaping the benefits of strong housing starts, and a general recovery in manufacturing. Housing starts in the U.S. rose 79% year over year in February, leading to a 20% increase in drywall prices in April. It's the speed of this recovery that has caught many off guard, including the bond market. Yields rise as inflation expectations rise.

As abruptly as the recession began, the pace of the recovery has been aided by central banks driving down borrowing rates, and by massive government stimulus packages. With many households having access to cheap money, people are waiting to get back to doing what they had been doing prior to the pandemic. The pace of vaccinations should also lead to renewed strength in the services sector (restaurants, travel and hospitality) in the coming quarters.

While inflation is expected to be elevated in the short term, we expect many of these inflationary pressures to moderate beyond this transition period. There are long established forces that keep it at bay. The shortages in the supply chain is a supply related, not a demand related problem. Time will solve these supply imbalances along with the associated price pressures. While the commodity sector is in a short term up cycle (Chart 2), we do not see this is the beginning of a new commodity super-cycle. There had been significant underinvestment by commodity businesses prior to the last super-cycle, which was just before China went on an absolutely massive infrastructure investment boom, spending 40% of their GDP on roads, bridges, and buildings. This is not something likely to be repeated.

Chart 2: Commodities on a tear – CRB Commodities Index (1 Year)

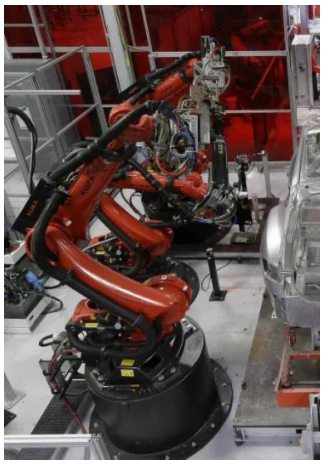


Source: Trading Economics

Prior to this pandemic, technology had been a deflationary force. While the current imbalances are likely to lead to higher inflation, at some point, technology's role in pushing prices lower will reassert itself. Price transparency that is made possible by a simple online search, forces retailers to be more competitive. Cloud based inventory management systems eliminate the need for the middleman and bypassing that step, lowers costs. Technology has also played a big role in containing labour costs, historically a major component of inflation. Step into a Wal-Mart or a Costco, and you see more unmanned checkouts than those with a cashier. Wal-Mart is rolling out "pick up towers", giant kiosks where customers pick up their online purchases without needing the help of an employee (picture 1). The production elements of a Tesla vehicle are almost 75% automated (picture 2). Pictures and videos of the company's factories show large robots doing the bulk of the vehicle builds. The trend towards greater automation is not likely to change.

Picture 1: Wal-Mart kiosk

Picture 2: Tesla robots



2021 will likely be the year of recovery, the year of getting back to some sense of normalcy. Bond yields have room to rise over the course of the year, and we think this will happen in waves. We don't see higher bond yields as a problem for the stock market, as they reflect optimism for economic growth. Simply put, good health and good economic news is good news for stocks, particularly when real bond yields (bond yields minus inflation) remain at low levels. While higher inflation numbers due to strong near term economic activity may add to some volatility in the stock markets, we don't see this changing our expectations for stocks to materially outperform bonds over the coming year.

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